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INSIGHTS FROM BDO'S NATURAL RESOURCES PRACTICE

BDO'S 12-MONTH ENERGY INVESTMENT OUTLOOK

By Clark Sackschewsky

The coronavirus pandemic has not only devastated everyday life but upended business as we know it. In the natural resources industry, COVID-19 has led to commodity price volatility, supply chain disruptions, capital access issues and project delays. According to our Forecast Engine Industry Impact Study, the natural resources industry has experienced the third largest decrease in revenue (32.8%) between January and May 2020.

Decreasing revenues has slimmed stakeholder returns and impacted investor sentiment, though each subsector of energy—oil & gas, power and renewables—have been impacted differently. In our 12-Month Energy Investment Outlook, we make predictions about the near future of each energy subsector and offer our quick take for companies to navigate industry headwinds and bolster capital access.

OIL & GAS

The oil & gas sector has been contending with low oil prices, mounting debt obligations and decreasing capital access since well before COVID-19. The pandemic has exacerbated these pressures, leading to even lower oil prices, sharp drops in demand and a widespread economic downturn, which further damped investor sentiment towards the sector. Based on these challenges, we've made the following predictions:

1. **Continued COVID-19 uncertainty will depress capital access.** Although some states have suppressed the infection curve, other areas across the U.S. are experiencing COVID-19 resurgences, which will lead to an extended overall decline in oil demand. Given the uncertainty around the course of the pandemic and swift impact to the sector's financial health that another nationwide resurgence would have, investors' sentiment towards the sector will likely remain lukewarm for the foreseeable future.

2. **More bankruptcies are on the horizon—and federal aid may not prevent them.** Tax incentives and direct federal aid provided under the CARES Act and Main Street Lending Program were meant to help businesses weather COVID-19's financial impacts, though the relief is likely not enough to outweigh the impact of low oil prices for many in the oil & gas sector. According to **Haynes & Boone**, at least 24 oil & gas companies filed for bankruptcy from April through June, and more are likely to follow in the coming months.

3. **M&A will provide opportunity…for those who can afford it.** As smaller, mid-sized and maybe even mid-major players file for bankruptcy, we expect an array of assets to come on the market in the coming year. Supermajors or those with deep pockets may scoop up these assets at bargain prices to leverage greater scale for increased operational and cost efficiencies aimed at improving their own profitability and market position.

BDO QUICK TAKE: In the current climate, business as usual won't protect revenue or retain investor interest. Oil companies facing financial hardship need to take a multi-pronged approach to ensure their survival and future viability: protect cash flow and improve operational efficiencies while looking further ahead towards their own energy transition. Improving cash flow management will require maintaining realistic capital expenditure programs, focusing on the most profitable oil fields with plans to operate those fields for longer periods of time. Boosting operational efficiencies in both the field and back office will result in lower costs per barrel, which creates new profit opportunities. On the energy transition front, oil and natural gas is not going away any time soon, but there is a strong movement into renewable energy that oil and gas companies can participate. The question may come down to build or buy—creating their own infrastructure or acquiring a smaller renewable company as means of entry into the space. They may even consider entering a strategic partnership with a renewable organization, leveraging their expertise with scale and operations as their value-add to the partnership, preparing them for the transition that is inevitable.

POWER

According to the International Energy Agency's (IEA) Gas 2020 report, COVID-19 is projected to cause the biggest drop in demand on record for natural gas—about a 150 billion cubic metric decrease, about twice of what the sector experienced during the Great Recession. The bulk comes from a significant decrease in commercial and industrial power use, despite the increase in residential power usage. Despite natural gas accounting for the lion's share of the U.S.' electrical mix, the sector has seen setbacks in the cancellation of the Atlantic Coast pipeline and the temporary shutdown of the Dakota Access pipeline, which may not bode well for future projects. The coal sector has been hit hard both by the overall power demand decline and competition from natural gas and even renewables, with the Energy Information Administration (EIA) projecting that coal consumption will decline by nearly a third this year. In the year ahead, we predict that:

1. **Sector recovery will be highly localized.** Commercial and industrial power demand will take longer to recover in localities that are still fighting to suppress the COVID-19 infection curve compared to areas that have been able to successfully reopen and remain open. This could lead to highly localized disparities in the power sector's recovery, with winners and losers determined by market-specific conditions.

2. **Investors will see utilities as a port in a storm.** As investors look to safeguard their capital from volatile market conditions, they may look to the utilities sector—particularly those with large residential customer bases. Utilities have the advantage of being an essential service and have access to a broader range of customers, which helps insulate them from the impacts of the pandemic and recession. Residential utilities may be the biggest winners, since residential power use has increased the most during COVID-19-related shutdowns.

3. **Coal will pivot to alternative energies.** According to the EIA, U.S. coal production fell to its lowest level since the national coal miner's strike of 1978, and it's likely to fall further as more coal-fired plants shutter their doors. While closure of more coal-fired plants is all but inevitable, we are likely to see more coal plants converting to natural gas. We may even see some coal operators dip their toes in renewable energy.

BDO QUICK TAKE: Power companies should monitor the course of the pandemic and business re-openings in their market to make more accurate projections of when power demand will recover and should manage their financial decisions accordingly. While the urgency for coal to pivot to alternative energy is clear, natural gas can't afford to rest on its laurels. Although it reigns supreme today, renewables will one day eclipse natural gas, according to EIA projections. To succeed in the long-term, natural gas organizations should start planning today for what the energy transition will means for their organization.

RENEWABLES

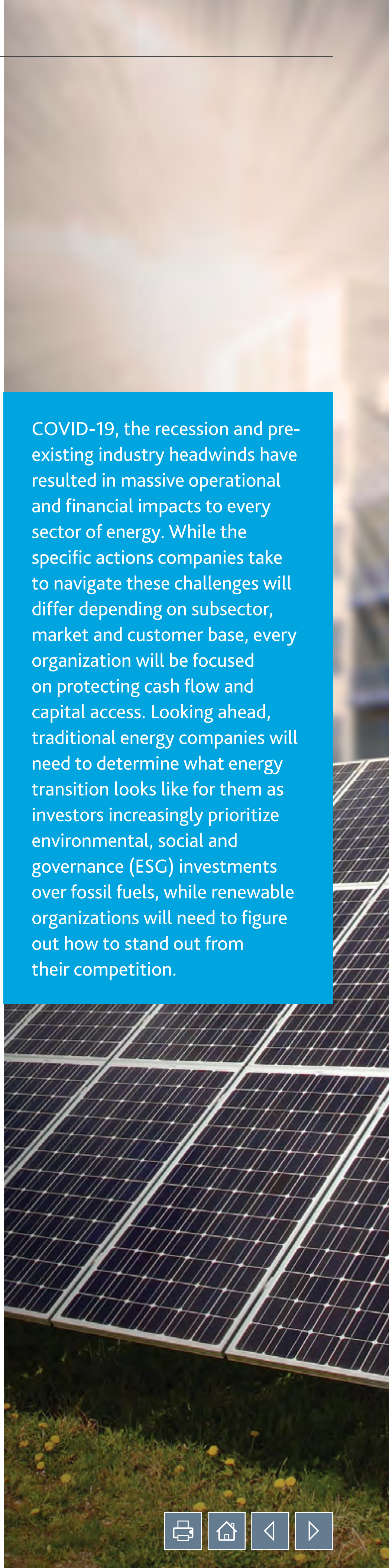
The past few months have been a mixed bag for the renewables sector. The pandemic and recession caused more than 620,000 job losses in the renewables sector between March and May, representing about 18% of the total industry workforce. The silver lining is that renewable energy reached an all-time high of 25.3% of the U.S.' net electrical generation in May, more than both coal and nuclear. The sector is not without its challenges, however. COVID-19 has caused global supply chain disruptions that have impacted project construction and it is unclear how long it will take the industry to recover from the recession. In the next year, we anticipate:

1. **Despite headwinds, renewables' growth will continue.** Although the full extent of the recession's impact on the renewable sector is yet to be understood, the long-term outlook is sunny. In some parts of the U.S, including California and Texas, wind and solar now produce electricity more cheaply than coal or even natural gas. As the industry and overall economy recover from COVID-19's aftershocks, we expect capital to continue flowing into the space as investor interest in sustainable projects will not abate.

2. **Renewables will revisit their supply chains.** In May, President Trump signed an executive order halting the installation of bulk-power system equipment from vendors controlled or supplied by a foreign entity and mandated companies to replace existing equipment to protect the U.S. grid from potential cyberattacks and espionage. The U.S. renewables sector relies heavily on imports from China, and so organizations will need to revisit their sourcing strategies to ensure they are only sourcing products from approved vendors. They will also be revisiting their sourcing strategies more broadly to improve supply chain resiliency to hedge against future disruptions.

3. **Microgrids will play a crucial role in energy transition.** According to a report from Wood Mackenzie, more microgrids were installed in the U.S. in 2019 than in any previous year. Reduced installation costs, continued technological innovation and government incentives helped spur this growth, and multiple projects arose from local municipalities' initiatives to expand renewable generation capacity. We expect microgrids to play an increasingly important role in U.S. energy transition as stakeholders look to increase grid resiliency, efficiency and sustainability.

BDO QUICK TAKE: In addition to taking actions to mute the financial impact of the recession—including protecting cash flow and maintaining a lean operating model—continued focus on innovation will be key for renewables to attract capital and scoop up market share. This could be accomplished through unique service offerings, such as providing customers with full visibility into their energy consumption mix and even enabling them to choose the source of their energy and pay for it accordingly. Renewables organizations could even partner with a manufacturer or tech company to produce energy efficient appliances for home or office use.



COVID-19, the recession and pre-existing industry headwinds have resulted in massive operational and financial impacts to every sector of energy. While the specific actions companies take to navigate these challenges will differ depending on subsector, market and customer base, every organization will be focused on protecting cash flow and capital access. Looking ahead, traditional energy companies will need to determine what energy transition looks like for them as investors increasingly prioritize environmental, social and governance (ESG) investments over fossil fuels, while renewable organizations will need to figure out how to stand out from their competition.

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